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Book Review: John Allison's The Financial Crisis and the Free Market Cure

By: John Tamney – October 17th, 2012

BB&T Bank has long been revered by those who think government has grown too close to the financial services industry. Led from 1989 until 2009 by the publicly libertarian John Allison, he took over as CEO when it was a small ($4 billion in assets) player in banking, and built it into a $152 billion financial behemoth. During that time, Allison was unique among CEOs (particularly in the heavily regulated banking industry) for regularly making the case that government was the problem, not just for banks, but for the economy more broadly.

Retired from BB&T in 2009, Allison took on a professorship at Wake Forest University, and then most recently he was appointed president of the libertarian Cato Institute (editor's note: I'm affiliated with Cato, though not in a policy capacity). Allison is nothing if not an expert on banking and finance, and having witnessed up close the 2008 financial crack-up that rendered so much of his competition insolvent, he's written an essential book on the causes of a financial crisis that he unapologetically concludes was born by government error.

About a third of the way through The Financial Crisis and the Free Market Cure, Allison writes that "It is impossible to have a systemic failure of the financial markets without mistakes by government policy makers being the primary cause." That's the theme of this highly readable and informative book, that the financial crisis wasn't financial as much as it was a creation of falsely compassionate government policies.

The problem, up to this point, is that much of the written history of the financial crisis has so far concluded that capitalism was the culprit. Allison disagrees, and writes early on that the "vast majority of the explanations for the crisis and the ensuing recession presented in the popular press are not true." From there he breezily slays countless myths about the financial crisis that have sadly been accepted by the broad commentariat as conventional wisdom.

This review will jump around, but since it's generally agreed that the rush to housing underlay the eventual economic contraction, it's best to start there. Allison begins by pointing out that since the 1930s, there "have been more subsidies for housing than for

any other economic activity." De Tocqueville wrote about Americans as being "restless amid abundance" with them always migrating to the best economic opportunities, so what a shame on its face that politicians would subsidize an activity that makes us less mobile. Some would say politicians like that which can't very easily move for reasons of taxation, but it seems the bigger driver is that politicians are politically correct creatures who like to give their constituents something for nothing.

Of course beyond the negative implications of housing policy from a mobility/tax standpoint, the biggest shame about housing subsidization is that it stimulates consumption over saving. Allison hits the latter on the head, makes the essential comment that "Housing is consumption" as opposed to investment, and then goes on to point out something that was utterly lost on conservatives and liberals during the recessionary rush into property, that if "government policy supports consumption at the expense of investment, we have less capital goods (including technology) to enhance the productivity of our labor force."

Allison's thinking here is very timely, particularly when we consider that Mitt Romney's top economic advisor, Glenn Hubbard, wrote an op-ed for the Wall Street Journal in December of 2008 in which he called for government action meant to raise "demand for housing" as the path to economic rebirth. Hubbard essentially turned Adam Smith's supreme logic (logic channeled by Allison) about savers being our ultimate benefactors on its head, and Allison corrects this.

Indeed, a frequent theme in the book is that the economic corrections we're experiencing are not the problem; to suggest otherwise the equivalent of the drunk decrying the hangover instead of the heavy drinking that led to it. Allison, quite unlike Republicans, Democrats and a Federal Reserve desperate to resuscitate the housing market, understands that the rush to housing was the recession for excessive growth capital flowing into the dead money sector that was housing over the productive economy.

To paraphrase Allison, if you build a house you employ people for just a time, whereas if you invest in a factory or new software, the investment feeds growth for years and years. Housing's not an investment, but even if readers want to believe it is, such an investment doesn't make us more productive, won't cure cancer or lead to economy-enhancing software innovations, nor does it open foreign markets. Were the political class more economically insightful, and perhaps not so wedded to banks, it would properly let existing home prices correct in concert with a collapse in housing starts so that always limited capital could more realistically migrate to more useful economic ideas.

Considering the drivers of the rush to housing, Allison unsurprisingly fingers Fannie and Freddie, among others. He writes that neither "would have existed in a free market", and then helpfully illustrates why with basic math. Both were levered up 1000 to 1, and to explain just how outlandish this was, he asks readers "How would you feel about your financial position if you had a net worth of $10,000 and owed $10,000,000?" Though both protested that they were non-governmental entities right up to when they were put into conservatorship, the numbers Allison cites reveal their past protests as grotesque.

If there's an area of disagreement there, it would have to do with his comment that if both had been allowed to default, "the global financial system would have collapsed." That seems hard to countenance, but even if true, the end result would have been a positive for ensuring that investors never again trust implicit government debt. Figure

after World War II Germany had lost a generation of its best people, its infrastructure was destroyed, and many of its citizens were living in caves. Within three years Germany was a thriving country again, and as defaults by Fannie and Freddie wouldn't have killed anyone, it seems the aftermath wouldn't have been as scary as he suggests.

Moving to the Federal Reserve, Allison doesn't pull any punches. Even better, to read the author's views on the Fed is to gain insights that only someone like Allison could offer for him having been so close to the action. Allison writes that the bank appointees to the Fed never impressed him, and about Alan Greenspan, he observes that "power not only corrupted him, but also destroyed his integrity." Commenting on the Fed's creation, he contends that it "was created to reduce volatility in the economy", and while that was certainly the headline explanation, it would be interesting if he'd commented on the perhaps conspiratorial assertion that says the Fed was created to prop up money center banks whose clocks were being cleaned by new entrants into finance of the bank and non-bank variety.

Allison asserts that banking is made more difficult by the Fed's existence. As he writes, banks are constantly managing their interest rate position, but the "difficulty of the task is doubled when, in addition to trying to examine real economic activity, one has to speculate on the whims of the chairman of the Federal Reserve." In that case, what a shame that the Fed presumes to set the cost of credit at all. Indeed, if the dollar is the single most important price in the world, and it is, then it's certainly true that the cost of credit is the world's second most important price. The Fed should float the short rate for credit that it sets to our detriment so that borrowing costs can more realistically reflect the marketplace.

Allison adds that big lurches in the fed funds rate wreak major havoc on the operations of banks. Specifically, he cites the 425 basis point increase in the funds rate from 2003 to 2007 that ultimately inverted the yield curve. Banks are of course in the business of lending, but with the short cost of credit higher than the long, this proved difficult, not to mention what it did to the value of assets already on their books. Allison points out the historical correlation between inverted yield curves and recessions, we eventually had one, but then he certainly acknowledges that the Fed's rate machinations were mitigated by "shadow" sources of finance whose lending could more easily reflect the Fed's errors.

The Fed engages in all this activity given its certainly fatal conceit that it can divine the economy. The problem, Allison writes, is that "In my career, the Fed has a 100 percent error rate in predicting and reacting to important economic turns."

On money, Allison channels Adam Smith yet again, and to good effect. Smith properly knew that the sole purpose of money is to facilitate the exchange of goods, while Allison writes that "Money is a standard of value that allows exchange to take place." Too bad this wildly true explanation of money in no way animates the Bernanke Fed. This is particularly true in light of Allison's contention that the "only way there could have been a bubble in the residential real estate market was if the Federal Reserve created too much money." More on money later, but it can't be stressed enough that when money is being debased, there occurs what Ludwig von Mises referred to as a "flight to the real."

In the above case, another regular theme in the book is the too often ignored truth that markets are always correcting themselves. Allison feels, and with good reason, that far from a source of economic stability, the Fed's monetary machinations were not allowing

markets that desperately needed correction to do just that. Here Allison reminds readers that before the Fed the U.S. "experienced a phenomenal growth rate" and that "Most economic corrections during this period, while sometimes deep, were short." Absolutely they were, and they were because recessions, though demonized by central bankers and their enablers in the political class, are actually a sign of an economy on the mend as it corrects all the resource misallocations of the investment and labor variety.

Despite the happy fact that free markets (Allison understandably views them as mixed, as opposed to totally free) have completely trounced central planning as a path to economic growth over the last 30 years, there still exists the belief within the commentariat, politicians and investors that the Fed can somehow fine tune the economy. Instead, the Fed slows our economic evolution given the simple truth that failure is the certain author of all economic advancement. In Allison's case he cites the story of Thomas Edison who, after 1,000 failed experiments, happened upon the lightbulb. In his own words, "For every Google or Microsoft, there are 1,000 failures, all of which are necessary." So true, and a clear reminder from Allison that the banking sector was weakened, not strengthened, by the bailouts.

Allison's solution to the Fed, something this reviewer agrees with wholeheartedly, is to abolish it in favor of a gold standard. To Allison, money is a measure, much like a yardstick is. When it's unstable as a measure of value commerce is compromised in much the same way that houses would take on asymmetric qualities if we floated the foot. Importantly, Allison does not call for price stability as so many naively do, because as he understands, "people are constantly changing their preferences, factors of production are changing, substitute products are being produced, capacity is expanded or contracting, and so on. In other words, the prices of individual goods will constantly be changing, but the price of all goods should not be changing because someone is arbitrarily increasing the amount of money (in effect, varying the length of the yardstick)."

A gold standard would bring credibility back to the yardstick. After that, the Fed's role of lender of last resort could easily be taken up by private entities; private entities much more likely to only lend to solvent banks per Walter Bagehot's admonition. If so, the economy and banking would be much better off for markets themselves regularly correcting bad lending and investments, not to mention forcing banks to evolve with the times; the well run financial institutions of the BB&T variety regularly acquiring the poorly run ones. Notable here is that Allison later in the book fingers Citigroup as a bank that's been bailed out at least three times in his career, and worse, "Each time, it has afterward become bigger and worse."

So while there's agreement that the monetary solution involves gold, there's perhaps disagreement about what kind of standard. Allison notes that annual new discoveries of gold amount to 2-3% of total supply, and that money growth should match this increase. As he puts it, the aforementioned discoveries would lead to "a steady growth in the money supply that modern-day central bankers have failed to replicate."

No doubt the above is true, but it seems gold's greater quality is that so minuscule are new discoveries relative to existing stock that gold itself is the standard money supply should be based on. Put more simply, gold's stability as a measure of value is a function of the stock/flow disparity (put in layman's terms, a sale of 1 million shares of Exxon Mobil isn't going to move the price much consider 6 billion shares are outstanding) that has long existed. That being the case, the desired gold standard is a price rule whereby

Treasury announces to the markets its intent to define the dollar in terms of gold six months in the future, the markets settle on a price within that time, and then going forward dollars are extinguished and created by a monetary authority (it wouldn't have to be the Fed) depending on the gold price itself. Gold's 10-year average at the moment is roughly $800, so the idea would be to target the latter price: if gold rises to $801 that's a signal that the dollar is over-issued, and then if it falls to $799, that's a signal that the markets desire more money. Let the market price of gold itself govern the supply of dollars.

The reason why is that no one can know just how many dollars the economy needs. John Stuart Mill long ago wrote that production is demand for money, so with a price rule, a booming economy would be met with booming money growth. Conversely, if the economy were to contract, meaning production were to decline alongside money demand, a price rule would require the contraction of the money supply in order to maintain the integrity of the unit of account. To this day it's said that a contraction in the money supply caused the Great Depression, but the greater truth is that money supply contracted precisely because economic activity did thanks to the Hoover and Roosevelt administrations erecting all manner of barriers to growth. Money is solely a measure, and its creation cannot drive economic activity.

Allison contends in light of the Fed's massive balance sheet increase that "If the economy begins to improve and the Fed does not withdraw the tremendous reserves it has created from the banking system, rampant inflation will follow." My own view is the opposite. The Fed's massive creation of banking reserves, something it theoretically could only have done with the consent of the White House and Treasury, was and is the inflation; today's near worthless CPI unable to broadcast what the spiking price of gold has been for years.

The economy is weak today precisely because inflation is not an if, rather it's a now. When money is debased, investment flows into the wealth (think gold, rare stamps, art, land, etc.) that already exists and that is least vulnerable to the monetary authority's devaluation. Conversely, when the value of money is rising or stable, like in the '80s and '90s, investment migrates away from the inflation hedges of yesterday and into the stock and bond income streams that represent future wealth creation that doesn't yet exist. Adam Smith warned us about stationary and backwards economies repelling investment, and monetary debasement leads to just that as investors essentially go on strike.

Back to the Fed, if the economy starts growing, its growth will likely be the result of a stronger dollar that lures investment out of inflation hedges and back into the productive economy. If so, a growing economy means more production, production is tautologically money demand, so an economy that's truly growing is one in which the Fed actually wouldn't need to withdraw funds. The problem now is that due to a weak dollar, one made weak by Treasury and Fed policy that says its creation is a stimulant, there will be no growth. There won't be per Allison's essential point that monetary policy itself is causing a massive and economy retarding misallocation of investment into the wealth of yesterday.

As for budget deficits, Allison argues that the Fed's very existence enables our federal government to run them up. He definitely has a point when we consider how the Fed has become a size buyer of Treasuries, but in the broad marketplace this assertion is less compelling. Indeed, if the existence of the Fed is seen as a dollar negative, why then

would debt that pays out dollars be easier to issue and sell? It's said that a gold standard would restrain the growth of big government, but figure our greatest deficits were run up during World War II precisely because the dollar had a fairly credible gold definition. Assuming a return to the dollar stability that only gold could bring, it seems unlikely that such a move would shut Treasury out of the debt markets. Probably the opposite. To reduce government spending we must return to constitutional principles that explicitly limit the scope of the federal government.

Regarding Allison's initially mentioned assertion that the creation of too much money by the Fed caused the recessionary rush to housing, the answer is yes and no. Money creation on its own is not necessarily an inflationary act if there's commensurate demand for the money being created such that the dollar doesn't decline in value versus gold. Here it can't be denied that while the Fed creates money, the U.S. Treasury is the dollar's mouthpiece. The Fed's balance sheet grew the same amount in the '70s as it did the '80s, the major difference one of the Nixon and Carter Treasuries regularly talking down the dollar compared to a Reagan Treasury (up until the '85 Plaza Accord) that initially stated its preference for a strong dollar.

The point of the above is to remind readers that in the 1970s interest rates were skyrocketing, the dollar was in freefall, and housing was the top "asset" class. In his 1981 classic Wealth and Poverty, George Gilder described the Carter housing boom this way: "What happened was that citizens speculated on their homes. … Not only did their houses tend to rise in value about 20 percent faster than the price index, but with their small equity exposure they could gain higher percentage returns than all but the most phenomenally lucky shareholders." Put plainly, and this was true in post-WWI Germany, not to mention 1970s England, when the monetary authority devalues the dollar, housing tends to do very well. This is true no matter the cost of credit, and as '70s vs. '80s money growth reveals, it's true no matter the Fed's machinations. Housing is alleged to have corrected, but the real, and economy-enhancing correction is yet to come if and when the U.S. returns to sound dollar policy so that the economy can start growing again.

Moving to the banking industry and its eventual crackup, Allison brings an immense amount of quality information to the discussion. Considering the FDIC, he's not a fan of it for it allowing consumers to gloss over the health of the banks they entrust with their money. Furthermore, the subsidy that is the FDIC is paid for by the big players, and it allows marginal players into the field that distort lending more broadly given their explicit backing.

Allison's discussion of banking regulations is worth the price of the book alone. That's the case because contrary to what you read in the popular press about a deregulated industry, he alerts readers to the greater truth that financial services is "probably the most regulated industry in the world." That didn't change during the Bush era, despite what you hear.

Allison points out that government spending on bank regulation actually increased from $725 million in 1980, to $2 billion in 2007. After that, we must remember that banks during the Bush years alone not only suffered the accounting nightmare that was Sarbanes-Oxley ("a redundant system on top of a redundant system"), but also the Patriot Act which, Allison writes "is one of the few ideas that is less useful than taking your shoes off to fly on a commercial airliner."

So while oversight of banks certainly increased during the time when the commentariat said they were essentially erased, Allison observes that "banking regulators are some of the least qualified people on the planet" to properly assess risk. Never one to pull punches, Allison adds that in his career, "there have been few, if any, occasions when the financial regulators identified a problem bank and acted in advance to correct the problems. In fact, in almost every case of bank problems or failures, government regulators have been the last people to know."

What the above tells us is that regulation is the problem, not the solution. Regulations create a false sense of comfort that a qualified person is overseeing their activities. What a laugh. Indeed, to presume that regulations of banks could ever work is to believe that the very individuals with such low ambition as to want to be regulators would have the ability to not just oversee the brightest financial minds on earth, but to also predict looming problems that those same bright financial minds are oblivious to. In the real world, these people are billionaire investors, and even they would acknowledge that they're rarely right more than half the time.

It's said by some that the individuals who work at ratings agencies are but one step ahead of regulators in terms of skill. It sounds true, and of course Allison reveals a clear lack of respect for their skills. That said, it seems a reach to finger them for any of the problems that eventually came up with regard to them giving inflated grades to mortgage securities that eventually went bust. Allison cites their protected government position, along with financial incentives to overrate securities, but this seems unfair. Not defending the ratings agencies for even a second (let's call them what they are – superfluous), but who were they to question a deep marketplace for mortgage securities in which there was a frenzied desire to buy up as many as possible? Figure John Paulson was a joke on Wall Street for shorting mortgage securities until he was no longer a joke, so to presume that ratings agencies could have moved against a powerful market tide seems a reach.

Moving to the banking crisis itself, obviously close to the action then, Allison discredits numerous myths in an entertaining way. Some point to massive derivatives markets in the "hundreds of trillions" of dollars as a factor, but as he correctly notes, "the vast majority of derivatives are entered into to reduce risk, not as speculation." Considering the amount of money involved, he reminds readers that the money "at risk" in derivatives markets is a "small fraction" of the amount actually being hedged.

And while it's popular to this day to suggest that Lehman Brothers' bankruptcy was the light that ignited the crisis fire, Allison alerts readers to the reality that Lehman was only a massive market event thanks to the bailout of Bear Stearns months before. The markets, having priced in a bailout of Lehman based on the savior of the much smaller Bear Stearns, learned the hard way what happens when overly interventionist governments change their policies on a daily basis. What they created was a lack of information, when information doesn't exist there's panic in the marketplace, but if Bear had been properly allowed to fail, Lehman either finds a buyer in order to save itself, or markets steeled for its looming bankruptcy prepare in advance.

Far from a failure of capitalism, the financial crisis was a failure of government intervention; specifically too much of it. But what makes Allison's book so valuable is the additional information he provides on all manner of occurrences from back when Democrats, Republicans and a hapless Fed lost their collective minds.

Specifically, Allison argues that the banking crisis ("financial crisis") really was born with the botched bailout of Washington Mutual. As he writes, "The FDIC, the Fed, and the U.S. Treasury made an extremely destructive decision in handling the failure of Washington Mutual." The problem this time was that in addition to making WaMu's insured depositors 100% whole, they did the same for the uninsured depositors. That was a problem simply because in traditional bankruptcies, the uninsured depositors had naturally taken a haircut, and the possibility of a haircut meant that they had a strong incentive to "impose discipline" on any reckless bank in which they housed their money.

In WaMu's case, the uninsured depositors were made whole on the backs of the bank's bondholders. As Allison writes, "the bondholders had expected significant losses on their bonds, but the losses were more than they had expected because the FDIC had taken part of the money that should have been available to pay bondholders and given it to uninsured depositors."

Why this matters is that the "decision to treat WaMu bondholders this way closed the capital markets for banks." Allison notes that BB&T had issued bonds a few weeks before the WaMu decision, but banks that needed debt finance after WaMu experienced much more skeptical markets. Allison argues that "this was an even more significant event than Lehman Brothers' failure."

As for the role of mark-to-market, or "fair value" accounting, Allison's analysis of this may perhaps be what emerges as the most controversial part of the book. Allison is a critic of mark-to-market given his view that it "distorts operating earnings and provides misleading and confusing information about the underlying earnings power of the business."

He goes on to write that "this distortion is particularly destructive when markets are not fully clearing because of external disturbances." Fair enough, but if a market is frozen, that's the market, and at times at least with some assets, it's probably wishful thinking that any frozen market will clear. Shouldn't asset prices reflect this?

Getting into specifics, Allison points out that if a bank marks it assets and takes a $50 million loss, "its capital is reduced by $50 million and its lending capacity by $500 million ($50 million x 10 = $500 million). Fair enough once again, but since banks are explicitly insured by the FDIC, and implicitly insured by the federal government (in Allison's defense, he likes neither the FDIC nor federal bailouts), shouldn't they reduce their lending at times when their balance sheets are impaired? A response to this might be that tight credit would exacerbate a recession, but isn't that the point of recessions, for banks to tighten credit so that no more of it is destroyed on bad ideas? Furthermore, as of 2008 banks only accounted for roughly 20% of corporate lending, so wouldn't non-bank credit substitutes fill the breech until things normalize?

Allison cites Bill Isaac, former chairman of the FDIC, who observed about mark-to-market that if had existed in the early '80s, there would have been mass failures of banks across the U.S. Maybe so, but to Allison's essential point that he's seen Citigroup bailed out three times in his career, wouldn't mark-to-market in the early '80s have saved taxpayers two more bailouts of Citi? Figure the U.S. computer industry is marked by 50 years of failure, and it's healthier for it. It seems banks are much weaker today thanks to bailouts of the financial and accounting variety that delay their necessary acquisition by

better managers, not to mention the capital destroyed over the years due to poorly run banks being given new leases on life.

Allison contends that "Accounting systems should never drive economic activity." No doubt that's true, and in this reviewer's eyes, fair value accounting is a bad idea. It's a bad idea not because of the problems it created for banks in 2008, but because banks should in a perfect, non-regulated world be able to individually choose their accounting methods. If so, investors in the marketplace would decide the best way to mark the value of assets, as opposed to valuation by government decree.

If so, it seems something resembling fair value would still carry the day. Indeed, Lehman failed not because it marked its assets down to fair value, but because investors asked to provide it with overnight operating funds didn't believe its overly generous marks. Whatever the accounting system, investors will have their own views on the value of balance sheets, and will mark accordingly.

Though very much against the bailouts (backdoor and front door) of the various financial institutions that occurred in 2008, Allison revealed some sympathy for Treasury Secretary Hank Paulson given his view that "it is difficult to assess all these positions during the heat of the crisis." Here I can speak somewhat knowledgeably in that I was at Goldman Sachs when Paulson was both vice chairman, and eventually CEO.

Paulson spoke to my summer associates' class in the summer of 1997, and when asked what kept him up at night, he replied that in a company of 10,000 individuals, one or two with one bad move could easily put the firm out of business. Paulson's point was that banks and investment banks have a highly ephemeral quality to them, so be careful. More to this point, it was a rite of passage for new employees on the first day of work to be presented with a deal tombstone from the '50s; the point there to show them just how few of those banks were still around. Once again, be careful, and be "long-term greedy" not because it sounds good, but because as Allison writes, "One of the powerful aspects of free-market economics is that the vast majority of the time (not always), when you treat your customers poorly, you will be punished. Free markets tend to be just, over the long run."

Along the lines of the above, Allison's point about the changing nature of the mortgage market didn't ring true to me. Though banks used to originate mortgages, then hold them on their books, in modern times "In the originate and sell model, once an originator sells a mortgage to a third party, it no longer cares about the risk." The problem with this assertion is that particularly on Wall Street, if you sell bad product to a big institution good luck getting your call answered the next time. Furthermore, if mortgage originators really thought they were selling dodgy mortgages to investors desperate to purchase them, then they wouldn't have had so much exposure to those same mortgage securities such that they were rendered insolvent in 2007-2008.

Back to Paulson, it seems he should have stuck to his pre-Treasury Goldman Sachs guns. Banks, and particularly investment banks, regularly fail. That's the business, that's why it pays so well, and it's pure folly to presume that the failure of Goldman, Morgan Stanley (ultimately just collections of financial talent that could have regrouped in smaller, boutique firms) would have led to the "Mother of All Great Depressions" as our hapless Fed Chairman Bernanke warned. Figure once again that if Germany could powerfully bounce back from the death and destruction of war, then the most talented country on

earth could have even more quickly recovered; the recovery stronger precisely because financial errors weren't bailed out. Or, as Allison put it, "It is very likely that without TARP, we would have had a deeper economic correction. However, it is also very probable that the correction would have been shorter and the long-term economic trend more healthy."

Was Goldman Sachs, and is Goldman Sachs a crony capitalist? Allison says yes, and his willingness to be so candid about the various players underscores what an important read his book is. That said, far from a demagogue on the matter, Allison reminds readers that "the problem is not Goldman. The problem is that politicians and bureaucrats have this power. If the U.S. Constitution were enforced, crony capitalism would not work because the politicians and bureaucrats would not have the authority to hand out favors to their friends."

As for the impact of TARP on Allison's BB&T, leaving aside the brilliant acquisitions his bank could have made on the cheap had the feds allowed markets to correct, BB&T was harmed because when it came to accepting TARP funds, it really had no choice in the matter. Allison writes that the "reward for running a good business is to have your worst competitors bailed out by the U.S. government and then to have massive new regulations that punish your company for sins it did not commit."

Allison writes that the "day after TARP passed, we were contacted by our regulators. This was an informal contact over the phone. I received a very carefully stated nondocumentable message. The essence of the message was that although BB&T had substantially more capital than it needed under long-established regulatory standards, given the currency economic environment, the regulators were going to create a new set of capital standards. They did not know what the standards would be. However, they were "very concerned" that we would not have enough capital under these new standards unless we took the TARP capital. They had a regulatory team in place to examine our capital position immediately unless we took the TARP funding. The threat was very clear." Translated, if you refuse the TARP money on the way to making your competitors look bad, we'll shut you down. Chilling.

Regarding Allison's solutions for the banking sector, though it's perhaps not my place to comment on something he knows much better, I'll say that I disagree with some of them. That he'd like to privatize or liquidate Fannie and Freddie is essential, and as for regulations of banking, I would up his desire to eliminate 90% of them to 100%. Allison's clear in the book that they're always late to problems as is, so why not get rid of them altogether?

He calls for an explicit rule that the Fed can't save non-financial institutions of the GE or GMAC quality, and while that makes sense, if we love the banks and investment banks, we must love that which would make them healthier, and that is letting them fail too when they err. Allison would eliminate the FDIC too, and with good reason. Absent the FDIC, insurance companies would quickly fill the role of insuring deposits absent the tragedy of the commons that comes with a government run insurance pool. It would then be cheap for depositors to house money with well run banks, and then more expensive to transact with ones thought to take on too much risk.

Where there's strong disagreement is in Allison's assertion that banks should be required to have substantially more capital; the number he'd like to migrate to 20%. He would no

doubt agree that this too is major regulation, and it's one that would tautologically reduce the ability of banks to be profitable. S&Ls were limited in the '70s in terms of their ability to offer depositors a market rate of interest, the result was that money market funds effectively rendered them irrelevant, but as S&Ls had political support much like banks do today, politicians kept them in business by relaxing the former requirements on interest paid and quality of loans. The end result was a major bailout of a politically connected sector of the economy in the late '80s.

Allison would no doubt agree that banks today are politically connected in the worst way, so if their ability to generate profits were constrained by nosebleed capital requirements, the latter would eventually be relaxed in order to keep those same banks in operation. Eventually some of those same banks would swing for the fences a la the S&Ls, and for having done so with the consent of politicians, taxpayers would once again be on the hook for their errors. Call it simplistic, but the single greatest fix for the banks would be a scrapping of all regulations that have never worked to begin with, followed by a one line law: If you fail, we will not cushion your failure. If so, banks will be forced to become smaller, leaner and more careful precisely because their depositors will require them to be. Conversely, to foist new profit sapping rules on them would be to set them up for future failure. Better for the feds to simply walk away so that markets can sort out the banks.

In a brilliant, must-read book about banking, finance and economics, Allison ultimately views the problems underlying our economy as philosophical. As he writes, "It is the combination of altruism and pragmatism that threatens our long-term well-being." Very true, because lest we forget, housing animated the crisis, and it only did given a desire within the political class to give Americans something for nothing. Fix the philosophy, erase the problems. In a free country whereby our lives are our own, what occurred in 2008 never could have. Simple as that.

John Allison has written easily one of the most important books of the year. Go out and buy it. You will not be disappointed.